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No. 03-1562

In the Supreme Court of the United States

HCA INC. & SUBSIDIARIES, SUCCESSOR TO HOSPITAL CORPORATION OF AMERICA & SUBSIDIARIES,

PETITIONERS,

V.

COMMISSIONER OF INTERNAL REVENUE,

RESPONDENT.

ON PETITION FOR A WRIT OF CERTIORARI TO THE UNITED STATES COURT OF APPEALS FOR THE SIXTH CIRCUIT

REPLY TO BRIEF IN OPPOSITION

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REPLY TO BRIEF IN OPPOSITION

Petitioners explained in their opening brief that this case presents a clear, persistent, and important conflict among the circuits on the standard of review for interpretive Treasury regulations, as well as a blatantly erroneous decision by the Sixth Circuit on a tax issue of great importance to the nation's healthcare industry. The Government's opposition brief responds with an exercise in misdirection—it argues that the questions presented by Petitioner do not merit this Court's review primarily by substituting in their place other questions that are not in dispute in this case.

The Government takes issue with the Sixth Circuit's express acknowledgment that it adopted a standard of review for interpretive Treasury regulations that differs from that of any other circuit. The Government insists that there is no conflict because all circuits applying *Chevron*[1] will uphold an interpretative Treasury regulation that is reasonable.

While, at a high level of generalization, it is correct that all circuits apply *Chevron* step two to interpretive Treasury regulations, the split in the circuits, which the Government simply ignores, is how the circuits determine whether the Treasury's statutory interpretation is reasonable. While all other circuits follow this Court's lead and apply the factors prescribed in *National Muffler Dealers Ass'n v. United States*, 440 U.S. 472 (1979), the Sixth Circuit expressly refuses to do so. The Sixth Circuit has acknowledged that its failure to apply the *National Muffler* factors results in a more deferential review than that employed by the other circuits. That distinction made a material difference in this case. Certiorari is warranted to resolve this conflict, as the validity of the Treasury's regulations should not differ depending on the region in which a taxpayer resides.

The Government's defense of the Sixth Circuit's ruling on the merits is equally baseless. Here, the Government

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[1] *Chevron, U.S.A., Inc. v. Natural Res. Def. Council, Inc.*, 467 U.S. 837 (1984).

(like the Sixth Circuit) states that I.R.C. § 448(d)(5) is ambiguous in the sense that it does not mandate use of a particular formula. That is not the question in dispute. The crux of this case is not whether, in the abstract, the Treasury can mandate the use of a formula for predicting the amount of receivables that will be uncollectible. It is instead whether the Treasury squarely violated the statute by requiring Petitioners to use a formula that forces them to accrue substantially all (approximately 80%) of the amounts that their experience indicates they will never collect. The Government's defense of the Sixth Circuit's ruling on that issue is paltry. Contrary to the Government's suggestion, the Treasury cannot satisfy the statute's prohibition against requiring taxpayers to accrue amounts that their experience indicates will be uncollectible by mandating that taxpayers use a formula that requires them to do just that.

The Government is equally incorrect (and about as forthcoming) in arguing that any question regarding the validity of the Treasury's interpretation of I.R.C. § 448(d)(5) has been mooted by its issuance of new regulations. Although the new regulations are more flexible in allowing taxpayers a choice among four mandatory formulas, they still fail to allow exceptions for taxpayers whose experience is not accurately captured by those formulas. Accordingly, the new regulations reflect the Treasury's view that, despite the plain language of the statute and Congress's express direction, it can continue to force taxpayers to accrue amounts that their experience indicates they will never collect. This case is an appropriate vehicle to correct that mistaken apprehension.

I. THIS COURT SHOULD GRANT CERTIORARI TO RESOLVE THE CIRCUIT CONFLICT ON THE STANDARD OF DEFERENCE OWED TO INTERPRETIVE TREASURY REGULATIONS.

The Government asserts that the circuit split about how much deference should be given to interpretive Treasury regulations is "illusory." According to the Government, the

Sixth Circuit's decision in *Peoples Federal Savings & Loan Ass'n v. Commissioner*, 948 F.2d 289 (6th Cir. 1991), followed by the Sixth Circuit here, is "not inconsistent with the other decisions cited by petitioners ..., all of which, like the Sixth Circuit, apply a deferential standard in reviewing the Treasury's interpretive regulations." Brief in Opposition at 14 ("Opp."). That observation is misleading. While all courts applying *Chevron* step two to interpretive Treasury regulations inquire whether the interpretation is reasonable, the courts that consider the *National Muffler* factors (this Court and eight other courts of appeals) use a different standard than the Sixth Circuit in determining what is reasonable, with dramatically different results. The Government seeks to gloss over these differences by resorting to the highest level of generality.

The Government's sleight of hand cannot withstand scrutiny. In the very case that the Government cites for the proposition that there is no difference between the traditional *Chevron* step two analysis and that applied under *National Muffler*, the Sixth Circuit expressly held to the contrary. In *Peoples*, the court stated that "the Tax Court used the wrong standard to decide this case. Entirely ignoring *Chevron* ..., the Tax Court employed the standard in *National Muffler Dealers* which seemed to allow a plenary review of the legislative history without the deference requirements found in *Chevron* and *Rust*." *Peoples*, 948 F.2d at 304. The Sixth Circuit then acknowledged that *Chevron* (without the *National Muffler* factors) "command[s] a greater degree of deference to administrative interpretations of congressional legislation where Congress has not addressed the specific point in issue." *Id.* at 304-05. The Government thus ignores the Sixth Circuit's plain language in *Peoples* when it asserts that no court of appeals has "expressly rejected the use of the *National Muffler Dealers* factors." Opp. 14.

The Government is equally incorrect when it contends that the conflict over the application of the *National Muffler* factors makes no substantive difference. Opp. 15. The Sixth

Circuit in *Peoples* expressly recognized the material difference *National Muffler* makes in the degree of deference afforded by *Chevron* when it reversed the Tax Court for having applied those factors. *Peoples*, 948 F.2d at 304. These factors also have been determinative in a variety of other decisions. The courts of appeals have upheld or invalidated numerous interpretive Treasury regulations solely or largely on the basis of the *National Muffler* factors. *See* Petition for Certiorari at 18 ("Pet."). And application of the *National Muffler* factors unquestionably would have altered the outcome in this case. Had the Sixth Circuit applied the *National Muffler* factors in its *Chevron* step two analysis, it would have issued a dramatically different decision, as each of those factors counsels against deference.

While the Original Regulation (which Petitioners followed) was substantially contemporaneous with the statute, the Revised Regulation, which employed a completely different formula, was adopted later.[2] Further, the manner in which the Revised Regulation evolved demonstrates an absence of thorough agency consideration. The Treasury did not subject the Revised Regulation to prior notice and public comment despite the absence of any urgency in promulgating the regulation. Agency interpretations that are issued without notice and comment rulemaking generally "do not warrant *Chevron*-style deference." *Christensen v. Harris County*, 529 U.S. 576, 587 (2000). Finally, not only did Congress never expressly or implicitly approve of the regulation, but the only time that Congress specifically addressed Section 448(d)(5) it rejected the Revised Regulation as contrary to the statute and directed

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[2] The Government's protest that the Revised Regulation was outstanding for fifteen years is disingenuous. Opp. 16. This case concerns the tax liability owing for the first year after the Revised Regulation was promulgated. The fact that the judicial process has taken years to reach this stage provides no basis for deferring to the Revised Regulation.

the Treasury to issue regulations that would not mandate the use of the Revised Formula. I.R.C. § 448(d)(5)(C) (2003).

The Government's assertion that Petitioners failed to preserve this issue is specious. Opp. 12. In its briefs to the Sixth Circuit, Petitioners asked the court to consider the principal *National Muffler* factors. Petitioners argued that the inconsistency of the Commissioner's interpretation should reduce the amount of deference given to the Revised Regulation. Final Reply Brief of Appellant at 22. Petitioners pointed out that the Commissioner's interpretation was not contemporaneous with the statute. Final Brief of Appellant at 14-15. And when Congress directed the Treasury to amend the Revised Regulation in 2002, Petitioners raised Congress's disapproval of the Treasury's interpretation at the first opportunity. Petition for Rehearing at 5. However, the Sixth Circuit, consistent with *Peoples*, ignored each of these factors in its *Chevron* step two analysis. Because the issue was thus raised and (by omission) passed upon by the court of appeals, it is unequivocally preserved for this Court's review. *Verizon Communications, Inc. v. FCC*, 535 U.S. 467, 530 (2002).

II. THIS COURT SHOULD GRANT CERTIORARI TO CORRECT THE SIXTH CIRCUIT'S BLATANT ERROR.

A. The Sixth Circuit's Ruling On The Merits Is Indefensible.

The Government argues that I.R.C. § 448(d)(5) is ambiguous, and thus invites deference under *Chevron* step two because the statute did not "unambiguously preclude[] the Treasury from mandating a formula to be used in calculating any adjustment." Opp. 10. That is just more sleight of hand. The dispute here is not whether the Treasury could require use of a formula to predict uncollectible amounts, but whether it could mandate use of a particular formula that cannot, for taxpayers with long collection cycles, accurately predict uncollectible amounts.

Section 448(d)(5) quite expressly provides a baseline requirement for whatever method the Treasury uses to predict the amount of uncollectible receivables—the method must predict the taxpayer's current uncollectible amounts based on the taxpayer's experience. Because the Revised Formula requires Petitioners to accrue in income amounts that their experience indicates will never be collected, it is flatly inconsistent with the plain text of the statute.[3]

Contrary to the Government's (and Sixth Circuit's) view, the Revised Formula does not predict a taxpayer's bad debts "based on [its] experience" just because it uses as inputs "'the bad debt history and accounts receivable of the hospitals, not some fictional entity.'" Opp. 7 (quoting the Tax Court's decision found at Pet. App. 52a). The statutory requirement that current bad debts be based on the taxpayer's experience can not be satisfied merely by plugging numbers taken from a taxpayer's experience into any formula. Whatever method is used must reflect estimates of a taxpayer's uncollectible accounts receivable based upon the taxpayer's historical experience in determining such amounts. The Government's contrary argument transforms the statute's substantive command into a silly and meaningless exercise.[4]

The Government does not deny that the Revised Formula grossly underestimates the bad debts of most taxpayers and required Petitioners to accrue in income 80% of the amount

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[3] Notably, the statute does not merely permit taxpayers to exclude from income uncollectible amounts but prohibits the Treasury from requiring any taxpayer to "accrue any portion of such amounts which (on the basis of experience) will not be collected." I.R.C. § 448(d)(5) (1987).

[4] A formula is not reasonable merely because it uses a taxpayer's bad debt history and accounts receivable data. Inserting two relevant numbers into a formula does not mean that the formula will provide the information sought. For example, while $e = mc^2$ is a wonderful formula for expressing the relationship between matter and energy, it is worthless in determining a taxpayer's bad debt experience even if one plugged in a taxpayer's year-end receivables for "m" and its bad debt history for "c."

that their experience indicated would not be collected. Yet it insists that the "mere fact that the regulation may have underestimated the amount of bad debt in petitioners' case ... does not demonstrate that the formula chosen by the Treasury is unreasonable" because "'[v]irtually *every* legal (or other rule) has imperfect applications in particular circumstances.'" Opp. 10 (quoting *Barnhart v. Thomas*, 124 S. Ct. 376, 382 (2003)). This argument is specious. A regulation that requires a taxpayer to accrue substantially all of the amounts that the taxpayer's experience indicates will not be collected fails to comply with the unambiguously expressed intent of Congress and therefore is *per se* unreasonable as to that taxpayer.

The Government's reliance on *Barnhart* is unavailing. In *Barnhart*, a former elevator operator applied for disability benefits. The Social Security Administration reviewed her claim within a five-step disability analysis, as required by its regulations. The fourth step of that analysis considered whether a claimant could perform his or her prior work (*i.e.*, in *Barnhart*, operating an elevator). If the claimant could perform the prior work, she was denied disability benefits without the Social Security Administration completing the fifth step (which queried whether a claimant could perform some work in the national economy). The claimant argued that the ability to perform one's prior work was an unreasonable proxy for the fuller determination of step five. The Supreme Court held that "Congress could have determined that an analysis of a claimant's physical and mental capacity to do his previous work would 'in the vast majority of cases' serve as an effective and efficient proxy for the claimant's ability to do *some* work that does exist in the national economy." *Barnhart*, 124 S. Ct. at 381. The Court thus approved the use of the proxy despite the fact that, in extremely limited instances, a person who could perform their previous work would be unable to do work that exists in the national economy.

The Revised Formula is not an example of such a proxy.

It did not work "in the vast majority of cases" or even in a majority of cases. In fact, it worked only for certain businesses, primarily utility companies, with unusually short collection periods. For Petitioners, it would require the accrual in income of 80% of the amounts that the statute explicitly prohibits the Treasury from requiring Petitioners to accrue (*i.e.*, those amounts that Petitioners' experience indicated would not be collected). The impact of this error on the nation's healthcare industry is in the hundreds of millions of dollars.[5] Thus the Revised Regulation was not an "imperfect application" that did not work only in "particular circumstances" as the Government implies. It was enormously "imperfect" because it failed to reflect most taxpayers' experience as commentators and practitioners recognized at the time it was issued. *See* Roy E. Strowd, Jr., *Nonaccrual-Experience Method of Accounting Causes Confusion and Concern*, 20 Tax Advisor 487, 488 (July 1989); *Practitioners Say Proposed Ratio for Bad Debts Does Not Reflect Experience*, Daily Tax Rep. (BNA) No. 232, at G-3, G-4 (Dec. 2, 1988).

The Government's defense of the Sixth Circuit's reliance on the legislative history of I.R.C. § 448(d)(5) is perplexing. In one breath, the Government acknowledges the confusion in the legislative history, noting that the House Report to the 1986 Tax Reform Act attempts to discuss a single formula but sets out two different formulas. Opp. 11. Yet in the next

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[5] The Government flippantly dismisses the impact of the Revised Formula upon Petitioners and others in the hospital industry by stating that any unfairness is ameliorated by the fact that the taxpayer can eventually deduct the underestimation when the debt is written off. (Opp. 10 n.5). But, of course, that is exactly what section 448(d)(5) was intended to prevent the Treasury from requiring taxpayers to do. Yet, as the Government admits, this is exactly what the Revised Regulation requires. If Congress believed the timing of income recognition was not relevant, it would not have repealed the cash method of accounting and the bad debt reserve method in the same Act that established the nonaccrual experience method.

sentence, the Government contends that the Treasury's mandate that all taxpayers use one of those two formulas in the Revised Regulation was reasonable because, whether or not that was the formula the Committee intended to describe, it appeared in the legislative history. That is pure nonsense. It was plain error for the Sixth Circuit to rely on admittedly ambiguous legislative history to bless an interpretive regulation that conflicts blatantly with the statutory text.

B. The New 2003 Regulations Do Not Moot The Importance Of This Case.

The Government protests that because the regulation at issue, Temp. Treas. Reg. 1.448-2T (1988), has been superseded by a temporary regulation, Temp. Treas. Reg. § 1.448-2T (2003), this case presents a question of "diminishing significance." Opp. 16. This argument fails to appreciate that the fundamental error at the heart of the Revised Regulation also plagues the 2003 temporary regulation. Neither reflects taxpayers' experience as the statute plainly requires. Rather than ensuring that each taxpayer's method reflects that taxpayer's bad debt experience, the Treasury confines taxpayers to the use of one of four fixed "safe harbor" formulas to compute uncollectible amounts, regardless of whether any reflect a taxpayer's bad debt experience. The Treasury thus continues to restrict taxpayers to a limited set of mandatory formulas, despite Congress's express instruction for the Treasury to approve taxpayer requests to use any "computation or formula that clearly reflects the taxpayer's experience." I.R.C. § 448(d)(5)(C).

Rather than honoring Congress's explicit instruction to approve such taxpayer requests, the Treasury devised an end run around this requirement. While purporting to authorize taxpayers to use methods of their choosing, the Treasury effectively eliminated that option by authorizing the use of alternative nonaccrual-experience method computations *only* if that alternative method does not produce a larger bad debt exclusion than would any of the safe harbors. Temp. Treas.

Reg. § 1.448-2T(e)(6)(iv) (2003). In other words, a taxpayer may use its own nonaccrual experience method only if that method produces as much tax revenue for the Treasury as would the regulatory safe harbors. That self-serving device hardly meets the statute's requirement, reiterated in the most recent legislation, that taxpayers be permitted to use any method that accurately reflects their bad debt experience.

Thus both the Revised Regulation and the Treasury's new 2003 regulation violate in the same way the congressional prohibition against forcing taxpayers to accrue income that their experience indicates they will not collect. While the formulas in the regulations differ, the underlying problem remains unchanged. Thus, this case remains an appropriate vehicle for enforcing the limits of the Treasury's authority under I.R.C. § 448(d)(5).

Not only does the Treasury's continuing refusal to permit taxpayers to exclude from income amounts that their experience indicates will be uncollectible, but, as amici explain, it more generally imposes a massive and unwarranted tax burden on the nation's healthcare industry. Brief of the Federation of American Hospitals at 11-16 (July 21, 2004). The imposition of tax on income that will never be collected exacerbates the financial burden created by the bad debt crisis facing our nation's hospitals.

CONCLUSION

The Petition for Certiorari should be granted. Indeed, Petitioners respectfully submit that summary reversal would be appropriate.

Respectfully submitted,

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